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The best way to play Kinder Morgan

Corporate structure designed for tax-exempt investors may benefit taxable investors, as well

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Recently there have been lots of articles written about the “kinder” (German for children) of Kinder Morgan.

There is Kinder Morgan Energy Partners LP (KMP), Kinder Morgan Management LLC (KMR) and Kinder Morgan Inc. (KMI).

Kinder Morgan Energy Partners is a master limited partnership. The other two aren't.

Investors find MLP taxation challenging, and thus we were curious about these other ways to invest with Kinder Morgan.

Recent investment analysis has compared the merits of Kinder Morgan Management and Kinder Morgan Energy Partners. I will confine this discussion to those two because they are so much alike economically.

Kinder Morgan Management, a corporation, owns nothing more than units in Kinder Morgan Energy Partners. Some wonder why the two don't trade at the same price.

Kinder Morgan Management trades at a discount to Kinder Morgan Energy Partners and therefore has a higher yield and historic return. Kinder Morgan Inc. will have to remain the neglected child, as its basic economics differ and make direct comparison difficult.

Those who own MLPs receive distributions in cash. Historically, about 20% of the cash is taxed at the highest rate, while the other 80% is not taxed until one sells or gives the MLP units as a gift. This point still is not well-understood by many advisers.

Tax-exempt investors such as pension plans can be taxed on their investment profits if the investment creates unrelated-business taxable income.

It is thought that ownership in MLPs would give rise to such income. This has kept the institutional community from investing in them.

And thus Kinder Morgan Management was born.

Kinder Morgan Management is taxed as a corporation, not a flow-through entity, and thus doesn't cause UBTI for tax-exempt investors. It doesn't own “regular” Kinder Morgan Energy Partners units. Instead, it owns i-units.

These i-units aren't paid cash distributions but instead are paid in more MLP i-units. In turn, Kinder Morgan Management doesn't make cash distributions but pays its “distribution” to shareholders in new KMR shares.

The difference between Kinder Morgan Energy Partners and Kinder Morgan Management has both cash flow and tax implications.

Ironically, this structure made for tax-exempts could turn out to be the optimum way for taxable investors to invest in MLPs, as well.

In our view, Kinder Morgan Management shouldn't be trading at a discount and might even deserve a premium to Kinder Morgan Energy Partners. Taxable investors might want to look hard at Kinder Morgan Management next time they decide to commit capital to Kinder Morgan.

Kinder Morgan Management's distribution of new shares is treated as a stock dividend. The receipt of more Kinder Morgan Management shares isn't a taxable event because stock dividends are considered nothing more than a stock split.

The investor is receiving distributions that won't be taxed unless the shares are ever disposed of. Any profits will be capital gains, not ordinary income.

The sale of MLP shares triggers the recapture of depreciation deductions. These depreciation deductions are the reason why just 20% of the MLP distributions are immediately taxable, while the rest is a return of capital.

Unlike return-of-capital distributions from corporations, these adjustments to basis are recaptured as ordinary income, not as capital gains.

The tax section of Kinder Morgan Management's Securities and Exchange Commission filings also advises that KMR shares are qualifying assets for regulated investment companies such as mutual funds and exchange-traded funds.

MLPs aren't qualifying assets for RICs. Most MLP mutual funds flunk this test and wind up paying a corporate level of tax.

The next paragraph of the filing concludes that non-U.S. investors in Kinder Morgan Management do not do business in the United States and thus do not owe tax here. Foreign investors in MLPs aren't so lucky. It is clear that from a tax standpoint, Kinder Morgan Management appears to be the better way to invest with Kinder Morgan for tax-exempt investors, taxable investors, mutual funds and foreigners.

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